

Phoenix Coal Inc.

Consolidated Financial Statements
December 31, 2008 and 2007

REPORT OF INDEPENDENT REGISTERED CHARTERED ACCOUNTANTS

To the Shareholders of Phoenix Coal Inc.

We have audited the consolidated balance sheet of Phoenix Coal Inc. (the Company) as at December 31, 2008 and the consolidated statement of operations and comprehensive loss, shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

(signed) Ernst & Young LLP

Louisville, Kentucky
March 17, 2009

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Phoenix Coal Inc.

We have audited the accompanying consolidated balance sheet of Phoenix Coal Inc. (successor to Phoenix Coal Corporation) (the Company) as of December 31, 2007 and the related consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the year ended December 31, 2007 which have been prepared on the basis of accounting principles generally accepted in Canada. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Phoenix Coal Inc. (successor to Phoenix Coal Corporation) as of December 31, 2007 and the results of its operations and its cash flows for the year ended December 31, 2007 in conformity with accounting principles generally accepted in Canada.

/s/ Mountjoy & Bressler, LLP

Louisville, Kentucky
May 2, 2008

PHOENIX COAL INC.
CONSOLIDATED BALANCE SHEETS
(Expressed in U.S. Dollars)

As at December 31

	Note	2008	2007
ASSETS			
Current Assets			
Cash and cash equivalents.....		\$ 40,525,609	\$ 381,374
Short-term investments	A	100,707	153,100
Trade accounts receivable		2,843,134	4,314,385
Accounts receivable — other		—	16,858
Coal inventories	A	452,558	1,072,697
Prepaid expenses and other current assets.....		470,506	526,664
Total current assets		44,392,514	6,465,078
Property, Plant and Equipment , net	E, K	46,037,904	29,028,582
Restricted Cash, Cash Equivalents and Certificates of Deposit	K	11,638,921	2,312,500
Mining Rights, Mine Development Costs and Mineral Reserves , net of accumulated amortization of \$3,670,570 in 2008 and \$210,658 in 2007.....	A, D	52,582,655	34,547,492
Other Assets		492,520	427,404
		\$ 155,144,514	\$ 72,781,056
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current Liabilities			
Trade accounts payable and accrued liabilities		\$ 6,470,390	\$ 8,896,898
Vendor financing.....	D	—	7,794,000
Preferred shares, subject to redemption provisions.....	G	—	45,635,369
Notes payable.....	G	—	5,526,785
Current portion of long-term debt	G	6,532,045	2,338,198
Current portion of asset retirement obligations	F	1,958,000	1,667,000
Total current liabilities		14,960,435	71,858,250
Asset Retirement Obligations, less current portion	F	2,366,000	2,090,353
Long-term Debt , less current portion	G	14,641,745	7,348,915
Other Long-term Liabilities		482,743	707,796
Shareholders' Equity			
Share capital.....	C, G	171,817,981	22,426,771
Stock options and warrants	L	16,625,724	1,458,884
Accumulated deficit		(65,750,114)	(33,109,913)
		122,693,591	(9,224,258)
		\$ 155,144,514	\$ 72,781,056

See accompanying notes to consolidated financial statements

Approved by the Board of Directors:

Robert Buchan (signed), Director

Robert Wardell (signed), Director

PHOENIX COAL INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(Expressed in U.S. Dollars)

For the Years Ended December 31

	Note	2008	2007
Revenue		\$ 76,724,270	\$ 67,184,104
Cost and Expenses			
Cost of sales		71,881,533	62,175,073
Selling expenses		8,188,945	7,859,571
General and administrative expenses	L	13,545,412	7,061,280
Depreciation and amortization	A	8,412,073	3,143,365
Asset impairment write down	A	—	2,873,055
		<u>102,027,963</u>	<u>83,112,344</u>
Loss from operations		(25,303,693)	(15,928,240)
Other Income (Expense)			
Interest expense, including accretion	G	(5,767,496)	(7,783,908)
Interest income		570,378	106,692
Foreign currency gain (loss)	G	129,130	(498,794)
Other, net	E	(1,014,424)	(1,816,730)
		<u>(6,082,412)</u>	<u>(9,992,740)</u>
Loss before income taxes		(31,386,105)	(25,920,980)
Income taxes	I	37,838	70,155
Net loss		<u>\$(31,423,943)</u>	<u>\$(25,991,135)</u>
Basic and diluted loss per share		\$(0.33)	\$(0.70)
Weighted average number of common shares outstanding	A	95,249,972	37,141,490
Comprehensive loss			
Net loss		\$(31,423,943)	\$(25,991,135)
Reclassification to net loss of loss on derivatives previously designated as cash flow hedges		—	143,858
Comprehensive loss		<u>\$(31,423,943)</u>	<u>\$(25,847,277)</u>

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Expressed in U.S. Dollars)

For the years ended December 31, 2008 and 2007

	Note	Common Shares		Stock Options and Warrants	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total
		Shares	Dollars				
December 31, 2006		36,392,667	\$ 21,040,818	\$ 47,224	\$ (143,858)	\$ (7,118,778)	\$ 13,825,406
Issuance of common shares		1,591,440	1,989,287	—	—	—	1,989,287
Common shares converted to preferred shares	G	(982,667)	(1,228,334)	—	—	—	(1,228,334)
Share-based compensation - options	L	—	—	948,859	—	—	948,859
Warrants issued in connection with preferred share offering	L	—	—	462,801	—	—	462,801
Share-based compensation – restricted shares	L	400,000	500,000	—	—	—	500,000
Exercise of stock options	L	300,000	125,000	—	—	—	125,000
Interest rate swap	G	—	—	—	143,858	—	143,858
Net loss		—	—	—	—	(25,991,135)	(25,991,135)
December 31, 2007		37,701,440	22,426,771	1,458,884	—	(33,109,913)	(9,224,258)
Share capital contribution - common shares issued in payment of loan fees	C, G	408,163	510,204	—	—	—	510,204
Issuance of common shares to settle debt	C, G	8,668,000	10,276,682	—	—	—	10,276,682
Conversion of preferred shares, including accrued dividends, to common shares	C, G	39,386,270	48,922,722	—	—	—	48,922,722
Value of additional shares issued in payment of debt	C, G	—	808,258	—	—	(808,258)	—
Share-based compensation - options	L	—	—	260,000	—	—	260,000
Balances – pre merger, pre share issue, and prior to recording loss for the year		86,163,873	82,944,637	1,718,884	—	(33,918,171)	50,745,350
Marimba Capital Corp. equity balances pre-merger	C	2,320,000	347,514	48,120	—	(88,255)	307,379
Marimba Capital shares consolidated on the basis of 1 share for every 2.35 shares outstanding	C	(1,332,769)	—	—	—	—	—
Reverse takeover adjustment	C	—	(88,255)	—	—	88,255	—
Reverse takeover costs incurred	C	—	—	—	—	(408,000)	(408,000)
Issuance of common shares	C	62,857,160	97,784,678	—	—	—	97,784,678
Issuance of warrants	C, L	—	(8,077,145)	8,077,145	—	—	—
Issuance of broker options	C, L	—	(1,106,286)	1,106,286	—	—	—
Share-based compensation - options	L	—	—	5,675,289	—	—	5,675,289
Options and warrants exercised	L	37,288	12,838	—	—	—	12,838
Net loss		—	—	—	—	(31,423,943)	(31,423,943)
December 31, 2008		150,045,552	\$171,817,981	\$16,625,724	\$ —	\$(65,750,114)	\$122,693,591

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Expressed in U.S. Dollars)

For the Years Ended December 31

	Note	2008	2007
Cash Flow From Operating Activities			
Net loss		\$(31,423,943)	\$ (25,991,135)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	A	10,729,602	5,607,126
Loss on sale of property and equipment	E	1,012,780	1,810,138
Interest rate swap	G	(224,696)	224,696
Unrealized foreign currency (gain) loss	G	(129,130)	81,227
Share-based compensation	L	5,935,289	1,448,859
Asset impairment write down	A	—	2,873,055
Reclamation liability	A	(730,436)	1,244,438
In-kind interest		—	350,000
Dividends accrued on preferred shares	G	1,467,165	1,277,838
Changes in non-cash operating assets and liabilities:			
Accounts receivable		2,018,442	(2,545,742)
Inventories	A	1,192,838	(816,314)
Prepaid expenses and other current assets		59,433	(280,545)
Trade accounts payable and other accrued liabilities		(3,901,965)	5,310,299
Net cash used in operating activities		(13,994,621)	(9,406,060)
Cash Flow From Investing Activities			
Restricted cash, cash equivalents, and certificates of deposit	K	(8,833,264)	(615,462)
Payments for investments		(100,707)	—
Proceeds from sales of investments		153,100	559,977
Payments for other assets, principally mine development and mining rights		(953,698)	(1,239,842)
Proceeds from sale of property and equipment	E	683,912	6,206,373
Payments for property and equipment	E	(3,683,110)	(1,549,511)
Net assets acquired in merger, prior to public offering		307,379	—
Acquisitions	D	(27,946,494)	(31,592,433)
Net cash used in investing activities		(40,372,882)	(28,230,898)
Cash Flow From Financing Activities			
Principal payments on debt	G	(1,058,337)	(21,618,644)
Proceeds from debt, net of financing fees	G	4,891,890	10,429,023
Payments on equipment financing	G	(6,486,279)	(1,007,250)
Reverse takeover costs incurred	C	(408,000)	—
Decrease in other long-term liabilities		(225,052)	(580,482)
Net proceeds from common and preferred share issuances and exercise of options and warrants	C, L	97,797,516	42,488,589
Net cash provided by financing activities		94,511,738	29,711,236
Net Increase (Decrease) in Cash and Cash Equivalents		40,144,235	(7,925,722)
Cash and Cash Equivalents, Beginning of Year		381,374	8,307,096
Cash and Cash Equivalents, End of Year		\$ 40,525,609	\$ 381,374
Supplemental Disclosure:			
Interest paid		\$ 2,179,725	\$ 6,814,827
Non-Cash Investing and Financing Activities:			
Vendor financing for equipment purchases	G	\$ 18,025,434	\$ 10,293,381
Shares issued in connection with acquisition	D	\$ —	\$ 543,300
Vendor provided financing of acquisition	D	\$ —	\$ 7,794,000
Receivable credited to acquisition	D	\$ 260,000	\$ —
Shares issued in payment of financing fees	G	\$ 510,204	\$ 862,500

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008 and 2007

NOTE A — NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations: The Company is engaged in the production and sale of steam coal to utilities and industrial fuel consumers. The Company's mining activities are currently limited to one reportable business segment, which is the Illinois Basin. On June 27, 2008, Phoenix Coal Corporation ("Phoenix") completed a reverse takeover ("RTO") of Phoenix Coal Inc. (the "Company"), formerly Marimba Capital Corp. ("MCC"), which was previously listed on the TSX Venture Exchange (note C). MCC was incorporated under the Business Corporations Act (Alberta) on February 8, 2007 and was classified as a Capital Pool Company as defined in the TSX Venture Exchange Policy 2.4 and, accordingly, had no assets other than cash and no commercial operations. MCC changed its name to Phoenix Coal Inc. on June 25, 2008. Phoenix, a U.S. company headquartered in Madisonville, Kentucky with satellite offices in Champaign, Illinois and Louisville, Kentucky, was formed in July 2004 as a Delaware C corporation and was originally named Dynamic Separations, Inc. ("DSI"). Where the context requires, in respect to transactions prior to the RTO, the "Company" also refers to Phoenix.

Principles of Consolidation: Pursuant to the RTO transaction, these consolidated financial statements for the years ended December 31, 2008 and 2007 reflect the assets, liabilities and results of operations of Phoenix prior to the RTO and the consolidated assets, liabilities and results of operations of the Company and Phoenix subsequent to the RTO. The consolidated financial statements are issued under the name of the legal parent (the Company), but are deemed to be a continuation of the legal subsidiary (Phoenix). The consolidated financial statements include Phoenix Coal Inc. and its subsidiaries, all of which are wholly-owned.

Basis of Presentation: The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All monetary references expressed in these notes are references to United States dollars, except occasional references to Canadian dollar amounts, where the dollar amount is preceded by Cdn ("Cdn\$").

Use of Estimates: The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The assets and liabilities which require management to make significant estimates and assumptions in determining carrying values include, but are not limited to, coal inventories, property, plant and equipment, mining rights, mine development, mineral reserves, prepaid royalties, provision for income taxes, and asset retirement obligations.

Reverse takeover accounting: The RTO was completed on June 27, 2008. Prior to the completion of the RTO, MCC affected a reverse split of its outstanding common shares on the basis of 1 new share for each 2.35 shares outstanding. Pursuant to the RTO, the Company issued one common share for each outstanding common share of Phoenix. In addition, warrants and options to purchase Phoenix common shares outstanding immediately prior to the RTO were replaced with warrants and options to purchase an equivalent number of common shares of the Company, on economically equivalent terms and conditions. The capital changes of the Company related to the RTO are detailed in note C to these consolidated financial statements.

Concurrent with the RTO, the Company raised \$97,784,678, net of issuance costs, in a prospectus offering of 62,857,160 subscription receipts priced at Cdn\$1.75. In connection with the RTO, each subscription receipt was exchanged for one unit, each unit consisting of one common share and one half common share purchase warrant exercisable until June 25, 2010 at Cdn\$2.25 per share.

The acquisition of the shares of Phoenix has been accounted for as an RTO transaction in accordance with guidance provided in Canadian Institute of Chartered Accountants' ("CICA") Emerging Issues Committee ("EIC") Abstract No. 10. As MCC did not qualify as a business for accounting purposes, the transaction has been accounted for as a capital transaction of Phoenix.

Business Combinations: CICA Handbook Section 1581 establishes standards for the recognition, measurement and disclosure of business combinations including criteria for the recognition of intangible assets of the acquired enterprise apart from goodwill. Initially, in all of the Company's previous acquisitions, including the acquisition of Pact Resources LLC

PHOENIX COAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008 and 2007

("Pact"), a development-stage enterprise, as described in note D, the amount of the purchase price in excess of the fair value of identifiable tangible assets was allocated in its entirety to goodwill. The Company has determined that in each of these acquisitions, the excess should have been allocated to mining rights. Consequently, on the June 30, 2008 and subsequent balance sheets, the Company has reclassified \$32,393,227, previously shown as goodwill at December 31, 2007, to Mining Rights, Mine Development Costs and Mineral Reserves. Other than this reclassification, the change in the purchase allocation in the Pact and other acquisitions has had no material impact on the reported financial position or results of operations of any prior period.

Financial Instruments: CICA Section 3855, "Financial Instruments – Recognition and Measurement", establishes standards for recognizing and measuring financial assets, financial liabilities, and non-financial derivatives. Under CICA 3855 financial instruments are classified into one of the following five categories: held for trading assets or liabilities, held to maturity investments, loans and receivables, available for sale financial assets or other financial liabilities. Held for trading financial instruments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Available for sale financial instruments are measured at fair value with revaluation gains and losses included in accumulated other comprehensive income until the instruments are derecognized or impaired. Loans and receivables, investments held to maturity and other financial liabilities are measured at amortized cost using the effective interest method.

The Company's financial instruments consist of cash and cash equivalents (including restricted cash), short-term investments, trade accounts receivable, trade accounts payable and accrued liabilities, other long-term liabilities, and short-term and long-term debt, including notes payable and preferred shares. Cash and cash equivalents are classified as held for trading, and are measured at fair value at the balance sheet date. Short-term investments are classified as held for trading and are measured at fair value at the balance sheet date. Accounts receivable are designated as loans and receivables and accounted for at amortized cost. Trade accounts payable and accrued liabilities, other long term liabilities and short-term and long-term debt, including preferred shares, are classified as other financial liabilities and accounted for at amortized cost. Transaction costs for financial instruments, other than held for trading, are included in the value of the financial instrument. Income and expense related to financial instruments is included in the consolidated statement of operations as interest income or interest expense.

Cash and Cash Equivalents: Cash and cash equivalents include demand deposits held with banks and highly liquid investments with original maturities of three months or less. For purposes of reporting cash flows, the Company considers all cash accounts that are not subject to withdrawal restrictions or penalties to be cash and cash equivalents.

Short-term investments: Short-term investments typically include certificates of deposit and investments issued by the United States government, such as Treasury bills and Treasury notes, with original maturities greater than three months. At December 31, 2008, the short-term investment balance of \$100,707 was entirely invested in certificates of deposit.

Trade Accounts Receivable: Trade accounts receivables are recorded at the invoiced amount and do not bear interest. Customers are primarily investment grade companies and quasi-governmental agencies. As a result, the Company has not experienced any instances of non-payment and does not currently require an allowance for doubtful accounts. Management monitors customers closely and will record an allowance if trade account balances become potentially uncollectible.

Inventory: The Company accounts for coal inventories on a first-in-first-out basis and values these inventories at the lower of cost and net realizable value with cost determined using average cost per ton. Coal inventory values were \$22.62 per ton at December 31, 2008 and ranged from \$21.99 to \$29.02 at December 31, 2007. At December 31, 2008, the total inventory value of \$452,558 was valued at net realizable value. At December 31, 2007, the total inventory value of \$1,072,697 comprised \$748,454 that was valued at cost and \$324,243 that was valued at net realizable value.

The Company accounts for parts inventory using the original cost on a first-in-first-out basis. Parts inventory is included in other current assets. There were no write downs or reversal of write downs of inventory recorded in 2008.

Restricted Cash, Cash Equivalents, and Certificates of Deposit: Restricted cash balances are either used to collateralize letters of credit, or secure reclamation bonds with state agencies. These assets will not be released until the reclamation bonds are released by the state, and as such are not included in current assets.

PHOENIX COAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008 and 2007

Property, Plant and Equipment: Property, plant and equipment are stated at cost. The Company provides for depreciation on the straight-line basis with useful lives that range from 5 to 10 years. Depreciation expense for the years ended December 31, 2008 and 2007 was \$4,364,650 and \$2,652,542, respectively.

The cost of assets sold, retired, or otherwise disposed of and the related accumulated depreciation are eliminated from the accounts and any resulting gain or loss is included in operations. Expenditures for maintenance and repairs are charged to expense as incurred. Expenditures for major renewals and betterments that extend the useful lives of property, plant and equipment are capitalized.

Interest cost is capitalized for qualifying assets during the period in which the asset is being installed and prepared for its intended use. Capitalized interest cost is amortized on the same basis as the related asset. No interest costs were capitalized for the years ended December 31, 2008 and 2007.

Consistent with CICA Section 3063, Impairment of Long-Lived Assets, the Company evaluates long-lived assets for impairment when events or changes in circumstances indicate that their carrying amount may not be recoverable. This impairment testing is based on estimated future undiscounted cash flows to be realized from the use of the long-lived asset. These future cash flows are developed using assumptions that reflect the long-term operating plans given management's best estimate of future economic conditions, such as revenues, production costs, and reserve estimates. A change in these factors could result in a modification of the impairment calculation.

Mine Development Costs: Mine development costs represent the costs incurred to prepare future mine sites for mining and are amortized on the units-of-production method. The net book value of mine development costs was \$1,681,147 and \$1,464,831 at December 31, 2008 and 2007, respectively. At December 31, 2008 and 2007, the net book value of mine development costs included \$1,446,478 and \$882,896, respectively, attributable to properties where the Company was not currently mining and, therefore, the mine development costs were currently not being amortized. Development costs amortized totaled \$665,243 and \$455,408 for the years ended December 31, 2008 and 2007, respectively.

Mining Rights: Mining rights, which are rights to mine coal properties acquired through coal leases, are recorded at cost. Mining rights are amortized on the units-of-production method. The net book value of mining rights totaled \$50,712,074 and \$32,893,227 at December 31, 2008 and 2007, respectively. At December 31, 2008 and 2007, the net book value of mining rights included \$45,627,773 and \$24,854,649, respectively, attributable to properties where the Company was not currently mining and, therefore, the mining rights were currently not being amortized. Mining rights amortized totaled \$3,382,180 and nil for the years ended December 31, 2008 and 2007, respectively.

In June 2007, the Company closed its Crittenden County Coal mining operation due to uneconomical mining conditions. As a result of the closing, the Company recorded an asset impairment write down related to its mining rights of \$2,873,055.

Mineral Reserves: Mineral reserves, which are coal properties for which the Company owns the coal in place, are recorded at cost. At December 31, 2008 and 2007, the net book value of mineral reserves totaled \$189,434. This entire amount is attributable to properties where the Company was not currently engaged in mining operations and, therefore, the assets were not currently being depleted.

Prepaid Royalties: Rights to leased coal lands are often acquired through royalty payments. Where royalty payments represent prepayments recoupable against production, they are recorded as a prepaid asset. As mining occurs on these leases, the prepayment is charged to cost of sales. Prepaid royalties were \$492,418 and \$80,683 at December 31, 2008 and 2007, respectively, and are included in other assets.

Asset Retirement Obligations: CICA Handbook Section 3110, "Asset Retirement Obligations," addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Company's asset retirement obligation ("ARO") liabilities primarily consist of spending estimates related to reclaiming surface land and support facilities in accordance with federal and state reclamation laws as defined by each mining permit.

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December 31, 2008 and 2007

Revenue Recognition: The Company recognizes revenue when all of the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the seller's price to the buyer is fixed or determinable, and (4) collectability is reasonably assured. In the case of coal that is mined and sold, a specific sales contract is negotiated with each customer, which includes a fixed-price per ton, a delivery schedule, and terms of payment.

Royalty Expense: The majority of the coal that the Company mines is owned by other entities. The Company acquires the right to mine and sell the coal through various leases. These leases require the Company to pay a royalty to the owners of the land and the minerals being mined. Royalty expense for the years ended December 31, 2008 and 2007 was \$3,778,642 and \$3,391,015, respectively, and is included in selling expenses on the consolidated statement of operations.

Income Taxes: Future income taxes are provided for temporary differences arising from differences between the financial statement and tax basis of assets and liabilities existing at each balance sheet date using substantively enacted tax rates expected to be in effect when the related taxes are expected to be paid or recovered.

Loss per Share: The Company uses the treasury stock method to compute the dilutive effect of options and warrants. Under this method the dilutive effect on loss per share is recognized on the use of the proceeds that could be obtained upon exercise of options and warrants. It assumes that the proceeds would be used to purchase common shares at the average market price during the year. The Company also uses the "if converted" method to compute the dilutive effect of any convertible debt. For loss per share, the dilutive effect has not been presented, as it would prove to be anti-dilutive. Basic and diluted loss per common share is calculated using the weighted-average number of common shares outstanding during the year. As a result of the RTO transaction, the basic and diluted loss per share has been presented in accordance with the guidance provided in EIC Abstract No. 10.

Stock-based compensation: The Company uses the fair value method for options, warrants and restricted stock granted. The fair value of stock options and warrants is determined by the Black-Scholes option pricing model with assumptions for risk-free interest rates, dividend yields, volatility factors of the expected market price of the Company's common shares and an expected life of the options and warrants. The fair value of the restricted stock is determined to be the equivalent of the Company's common shares' trading price on the date of the grant. The fair value of the instruments granted is amortized over this vesting period.

Foreign currency translation: The Company translates monetary assets and liabilities at the rate of exchange in effect at the balance sheet date and non monetary assets and liabilities at historical exchange rates. Revenues and expenses are translated at rates prevailing at the dates of the related transactions.

New Accounting Policies:

Capital Disclosures: Effective January 1, 2008, the Company adopted CICA Handbook Section 1535, Capital Disclosures. Handbook Section 1535 specifies the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such noncompliance. The Company has included disclosures recommended by the new Handbook section in note B to these consolidated financial statements.

Inventories: Effective January 1, 2008, the Company adopted new accounting recommendations set out in the CICA, Handbook Section 3031, "Inventories", which supersedes the previously issued standard on inventory. The new standard introduces significant changes to the measurement and disclosure of inventory. The measurement changes include: the elimination of LIFO, the requirement to measure inventories at the lower of cost and net realizable value method for inventories that are not ordinarily interchangeable and goods or services produced for specific purposes, the requirement for an entity to use a consistent cost formula for inventory of a similar nature and use, and the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. Disclosures of inventories have also been enhanced. Inventory policies, carrying amounts, amounts recognized as an expense, write-downs and the reversals of write-downs are required to be disclosed. This standard has had no material impact on the Company's consolidated financial statements.

Financial Instruments - Disclosures and Presentation: Effective January 1, 2008 the Company also adopted the following new CICA Handbook Sections: Section 3862, Financial Instruments Disclosures, and Section 3863, Financial Instruments

PHOENIX COAL INC.

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Presentation. Sections 3862 and 3863 consist of a comprehensive series of disclosure requirements and presentation rules applicable to financial instruments. Section 3862 revises and enhances the disclosure requirements set out in Section 3861, Financial Instruments Disclosure and Presentation, and Section 3863 carries forward unchanged the presentation requirements of Section 3861. Section 3862, Financial Instruments Disclosures, requires the Company to provide disclosures in its financial statements that enable users to evaluate the significance of financial instruments for the Company's financial position and performance, the nature and extent of the risks arising from financial instruments to which the Company is exposed during the year and at the balance sheet date, and how the Company manages those risks. The Company has included disclosures recommended by the new Handbook section in note H to these consolidated financial statements.

Amendments to Section 1400 - General Standards of Financial Statement Presentation: The CICA amended Handbook Section 1400, Going Concern, to include additional requirements to assess and disclose an entity's ability to continue as a going concern. The Company has determined that these amendments had no material impact on the Company's consolidated financial statements.

Future Accounting Changes:

Goodwill and Intangible Assets: The CICA has issued a new standard which may affect the financial disclosures and results of operations of the Company for interim and annual periods beginning January 1, 2009. Section 3064, Goodwill and intangible assets, establishes revised standards for recognition, measurement, presentation and disclosure of goodwill and intangible assets. Concurrent with the introduction of this standard, the CICA withdrew EIC-27, Revenues and Expenses during the pre-operating period.

International Financial Reporting Standards ("IFRS"): In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. In February 2008, the AcSB announced that Canadian GAAP for publicly accountable enterprises will be converged with IFRS effective in calendar year 2011. The Company will adopt IFRS for the fiscal year beginning January 1 2011, with restatement for comparative purposes of amounts reported by the Company for the fiscal year beginning January 1, 2010.

The Company is currently in the planning phase of the conversion, which includes identifying potential differences between GAAP and existing IFRS at December 31, 2008, as well as proposed IFRS which may be in effect in 2011. The Company is utilizing both internal and external resources to identify and ultimately quantify these differences and the impact that they will have on accounting policies, information technology and data systems, internal control over financial reporting, disclosure controls and procedures, financial reporting, and business activities. Employees responsible for financial reporting will attend IFRS training and begin IFRS accounting policy development in 2009.

Reclassifications: Certain of the 2007 figures have been reclassified to conform to the 2008 financial statement presentation.

NOTE B – CAPITAL MANAGEMENT

The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company, in order to support the acquisition, exploration and development of its mineral properties. The Board of Directors does not establish quantitative return on capital criteria for management, but rather relies on the expertise of the Company's management to sustain future development of the business. The Company defines capital to include its shareholders equity, long and short-term debt, vendor financing, and its preferred shares. Capital, as defined, totaled \$143,867,381 and \$59,419,009 at December 31, 2008 and 2007, respectively.

The mineral properties in which the Company has an interest are in both the active mining and development stages. The Company manages its capital structure in a manner that provides sufficient funding for operational activities, capital expenditures, and mine development. Funds are secured through a combination of equity capital and external debt. In order to maintain or adjust the capital structure, the Company may attempt to raise additional financing through the issuance of new equity securities, the exercise of outstanding common share warrants and stock options, or the issuance of debt instruments such as term loans, equipment financing, and sale-leaseback arrangements.

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During the years ended December 31, 2008 and 2007, the Company generated cash flows from equity capital and external debt as follows:

	2008	2007
Proceeds from debt, net of financing fees.....	\$ 4,891,890	\$ 10,429,023
Net proceeds from common share, warrants and preferred share offerings and exercise of options and warrants	97,797,516	42,488,589
Vendor financing of equipment purchases and acquisitions.....	18,025,434	18,087,381
Total proceeds from equity capital and external debt.....	\$ 120,714,840	\$ 71,004,993

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is reasonable. There were no changes in the Company's approach to capital management during the year ended December 31, 2008. Neither the Company nor its subsidiaries are subject to externally imposed capital requirements.

NOTE C — RTO AND RELATED CAPITAL ACTIVITY

On May 22, 2008, MCC and Phoenix entered into a definitive merger agreement with respect to the RTO discussed in note A. On May 22, 2008, MCC also filed a preliminary prospectus for an offering (the "Offering") of Subscription Receipts (the "Subscription Receipts"), each Subscription Receipt entitled the holder to receive one unit (a "Unit"), each Unit consisted of one common share of MCC and one-half of one warrant of MCC, subject to the satisfaction of certain conditions. MCC applied to have the common shares and warrants listed on the Toronto Stock Exchange (the "TSX"). The Subscription Receipts were offered to the public in all of the provinces of Canada, except for Quebec, and in the United States in an offering exempt from the registration and prospectus requirements of the U.S. Securities Act. Subject to applicable law, the agents acting in connection with the Offering also offered the Subscription Receipts outside of Canada and the United States. The Offering consisted of 62,857,160 Subscription Receipts at a price of Cdn\$1.75 per Subscription Receipt to raise gross proceeds of Cdn\$110,000,030.

Pursuant to an agreement among MCC, Phoenix and the Offering agents, the agents received a cash commission equal to 6% of the gross proceeds of the Offering plus compensation options equal to 4% of the Subscription Receipts sold pursuant to the Offering.

A summary of the gross proceeds received and Offering costs incurred is as follows:

Gross proceeds (Cdn\$110,000,030 converted to U.S. dollars at a conversion rate of 0.99007 U.S. to Cdn)	\$ 108,908,500
Agents' fees	(6,534,510)
Other out-of-pocket costs.....	(4,589,312)
Net proceeds	\$ 97,784,678

In addition to the Offering costs, the Company incurred \$408,000 in costs related to the RTO which have been treated as a capital transaction and charged to accumulated deficit.

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Common and preferred share activity in 2008, up to and including the RTO closing date, is detailed as follows:

Phoenix Common Shares Issued – 105,000,000 authorized, \$.001 stated value per share	Number of Shares	Amount
Balance, December 31, 2007	37,701,440	\$ 22,426,771
Conversion of finance company debt to common shares, including EIC – 96 adjustment – note G.....	8,668,000	11,084,940
Issued for fees on payment of debt – note G	408,163	510,204
Conversion of preferred shares to common shares – note G.....	37,190,267	46,177,718
Issued to settle dividends on preferred shares – note G.....	2,196,003	2,745,004
Balance June 27, 2008, pre RTO	<u>86,163,873</u>	<u>\$ 82,944,637</u>

Phoenix Preferred Shares Issued – 40,000,000 authorized, \$.001 stated value per share	Number of Shares	Amount
Balance, December 31, 2007, excluding accrued dividends of \$1,277,839.....	37,190,267	\$ 44,357,530
Accretion of preferred share offering costs	—	1,820,188
Conversion of preferred shares to common shares – note G.....	<u>(37,190,267)</u>	<u>(46,177,718)</u>
Balance, June 27, 2008.....	<u>—</u>	<u>\$ —</u>

MCC and Company Common Shares Issued – unlimited authorized	Number of Shares	Amount
Balance, December 31, 2007	2,320,000	\$ 347,514
Consolidated on the basis of 1 share for every 2.35 shares outstanding – note A	<u>(1,332,769)</u>	<u>—</u>
Balance after consolidation.....	987,231	347,514
Issued in public offering.....	62,857,160	97,784,678
Reverse takeover adjustment.....	—	(88,255)
Value of broker options and shareholder warrants issued with public offering.....	—	(9,183,431)
Share capital arising from RTO transaction on June 27, 2008 – note A.....	<u>86,163,873</u>	<u>82,944,637</u>
Balance June 27, 2008, post RTO.....	<u>150,008,264</u>	<u>\$ 171,805,143</u>

NOTE D — ACQUISITIONS

C&R Coal Inc.

In July 2008, the Company's subsidiary, R&L Winn Inc. ("R&L Winn"), purchased all of the outstanding common shares of C&R Coal Inc. ("C&R") for cash consideration of \$2,051,000. In addition, under the terms of the agreement, R&L Winn will pay the former owners a royalty of \$0.60 per ton for each ton of coal sold from the C&R mines. The current mining area, Beech Creek and Beech Creek South, contained approximately 450,000 reserve tons (697,000 reserve tons as at December 31, 2007 pursuant to the Company's National Instrument 43-101 revised technical report less coal mined in the first seven months of 2008) as at July 31, 2008. R&L Winn also acquired other leases in the transaction from C&R and R&G Leasing, LLC, a company that is affiliated with C&R through common ownership. Based on exploration completed to date by the Company, management estimates the leases contain approximately 1,500,000 tons of coal. The potential quantity is conceptual in nature as there has been insufficient exploration to define a mineral resource and it is uncertain that further exploration will result in the delineation of a mineral resource.

The cost of the C&R acquisition was allocated to the following identifiable net assets:

Current assets and restricted certificates of deposit	\$ 1,281,000
Mining equipment.....	859,000
Mining rights and mine development costs	2,387,000
Assumed liabilities.....	<u>(2,476,000)</u>
	<u>\$ 2,051,000</u>

Prior to July 2008, the Company operated and managed C&R's mines under a management and administrative services agreement. Since the Company did not own nor control C&R, it did not consolidate its operating results prior to July 2008, and recorded funds invested and services provided in other assets and accounts receivable on its balance sheet, which totaled \$612,751 at December 31, 2007.

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Renfro Equipment, Inc.

In July 2008, the Company purchased all of the outstanding common shares of Renfro Equipment, Inc. ("Renfro") for total cash consideration of \$1,129,000. Additionally, the Company incurred \$18,000 of closing costs. The purchase included all assets and liabilities of Renfro, except certain equipment and associated debt specifically excluded from the purchase. Based on exploration completed to date by the Company, management estimates Renfro controls approximately 1,000,000 tons of coal reserves and 465,000 resource tons via lease. The potential quantity is conceptual in nature as there has been insufficient exploration to define a mineral resource and it is uncertain that further exploration will result in the delineation of a mineral resource. Additionally, if by the second anniversary of the closing date, the Company acquires at least 1,500,000 reserve tons as defined by National Instrument 43-101 due to the direct efforts of the sellers (the "Additional Reserves"), the Company will pay the sellers \$1,000,000 for the first 1.5 million tons of reserves, plus \$0.50 per ton for each reserve ton in excess of 1.5 million. The share purchase agreement defines a specific territory from which the Additional Reserves can be acquired. The acquisition of the Additional Reserves is on terms and conditions acceptable to the Company in its sole, reasonable discretion.

The cost of the Renfro acquisition was allocated to the following identifiable net assets:

Current assets and restricted certificates of deposit	\$	334,000
Mining equipment.....		429,000
Mining rights and mine development costs.....		1,770,000
Assumed liabilities.....		(1,386,000)
	\$	<u>1,147,000</u>

The Company is in the process of finalizing its valuation of the assets acquired and liabilities assumed for both the C&R and Renfro acquisitions. The above allocations are preliminary estimates of fair value and may differ from the final allocation and the differences may be material. The Company will finalize the allocations within one year of the acquisition dates.

Pact Resources LLC

In October 2007, the Company acquired the membership interests in Pact Resources LLC ("PACT") upon exercising its option in September 2007 pursuant to the option agreements dated September 7, 2006 (the "Option Agreements"). Through the acquisition of PACT, the Company controls the leases for the proposed Pratt Mine within the area of interest as defined in the Option Agreements. The proposed Pratt Mine contains both underground and surface coal totaling 33,833,000 tons of measured and indicated resources, 670,000 tons of inferred resources and 28,933,000 tons of proven and probable reserves. The Company has been carrying out development work on the proposed Pratt Mine since the fourth quarter of 2006, and in August 2008 received a state permit which will allow the Company to begin construction on the Pratt Mine.

In addition to the leases for the proposed Pratt Mine, the sellers of PACT delivered to the Company the lease for the Panama South property, which is described further below. As a result, the in-place tons associated with the Panama South property were included in the calculation of the Scheduled Payment (as described below). The Panama South property contains both underground and surface coal totaling 76,287,000 tons of measured and indicated resources.

Pursuant to the Option Agreements, in addition to the scheduled payment for in-place tons of coal delivered by the sellers (the "Scheduled Payment"), which payment terms would be subsequently modified, the Company agreed to pay \$300,000 (the "Option Fee") at the effective date of the Option Agreements, an overriding royalty no greater than 3% of the gross sales price per ton sold from the proposed Pratt Mine (the "Overriding Royalty") and expenses related to the development of the proposed Pratt Mine during the option period (the "Pratt Expenses"). Prior to the closing of the acquisition, the Company and the sellers of PACT modified the original Option Agreements and entered into modification of option agreements (the "Modification of Option Agreements"). The Modification of Option Agreements stipulated that the Scheduled Payment was \$15,000,000 payable in three installments, \$10,000,000 of which was paid in 2007, plus a true-up payment of \$0.10 per in-place ton on September 7, 2008 for any additional tons of coal greater than 150,000,000 in-place tons that the sellers deliver. As at December 31, 2007, the Company estimated that the sellers had already delivered 177,940,000 in-place tons of coal for a total Scheduled Payment of \$17,794,000. As such, the Company recorded an additional \$7,794,000 of vendor

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financing on its consolidated balance sheet due to the former owners of PACT as at December 31, 2007. Of this amount, \$5,000,000 was originally payable in April 2008, with the balance due in September 2008.

On March 31, 2008, the Company entered into a buy-out agreement with the former owners of PACT, which was subsequently amended in June 2008 (collectively the “Buy-out Agreements”). Under the terms of the Buy-out Agreements, if the Company either completed a public offering of its shares, sold (in a private sale) more than 50% of its issued and outstanding shares or more than 50% of its assets, or completed an RTO (the “Monetization Event”), the Company would pay the former owners of PACT \$25 million (the “Buy-out Payment”). Pursuant to the Buy-out Agreements, Phoenix’s obligations to make a \$5 million payment in April 2008 and the balance in September 2008 were suspended until the occurrence of a Monetization Event. Upon receipt of the Buy-out Payment, all obligations of Phoenix to make any additional payments, including the accrued amount on the consolidated balance sheet as at December 31, 2007 and future overriding royalty payments, would cease and terminate. In the event the Monetization Event was an RTO, and the offering was not closed on or before July 1, 2008, then all obligations of the Company to make additional payments to the former owners of PACT for the PACT properties would be reinstated at that time.

On June 27, 2008, the Company completed the RTO and paid \$25,000,000 to the former owners of PACT on June 30, 2008. At December 31, 2007, Phoenix’s acquisition costs in PACT totaled \$18,909,000. With the \$25,000,000 Buy-out Payment paid on June 30, less the vendor financing of \$7,794,000 previously recorded at December 31, 2007, the acquisition costs increased by \$17,206,000 during the year ended December 31, 2008, with a corresponding increase in mining rights.

The Company’s total acquisition cost of PACT is comprised of the Option Fee, Pratt Expenses, the Scheduled Payments, and the Buy-out Payment which total \$36,115,000 (the “Purchase Price”) at December 31, 2008 and \$18,909,000 at December 31, 2007 as follows:

	2008	2007
Option Fee	\$ 300,000	\$ 300,000
Pratt Expenses.....	815,000	815,000
Scheduled Payments and Buy-out Payment.....	35,000,000	17,794,000
	\$ 36,115,000	\$ 18,909,000

The Purchase Price was allocated to the following identifiable net assets:

	2008	2007
Cash	\$ 3,000	\$ 3,000
Advance royalties	42,000	42,000
Land purchase option.....	75,000	75,000
Mining rights and mine development costs	35,995,000	18,789,000
	\$ 36,115,000	\$ 18,909,000

At the acquisition date, the owners of PACT owned less than 1% of the total outstanding shares of Phoenix and also held 300,000 options to purchase common shares of Phoenix. The PACT purchase price was negotiated by members of senior management that had no financial ownership in PACT and the acquisition was considered to be an arms-length transaction.

During 2008, the Company finalized the purchase allocation and related valuation of the assets acquired and liabilities assumed for the PACT acquisition. Initially, the purchase price in excess of tangible and identifiable assets was allocated to goodwill. However, as PACT is a development stage enterprise which has not yet commenced commercial production, the Company has concluded that the allocation should be to acquired mining rights as explained more fully under “Business Combinations” in note A.

Panama South

In December 2007, the Company entered into a lease with Penn Virginia Operating Co., LLC for the right to mine its Panama South property, located in Webster County, Kentucky, which contains both underground and surface coal totaling 76,287,000 tons of measured and indicated resources. In connection therewith, the Company paid a non-recoupable fee of

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\$500,000. The lease outlines three terms: (1) the development term (the “**Development Term**”), from the effective date of the lease until December 31, 2011; (2) the primary term (the “**Primary Term**”), from the end of the Development Term until the earlier of: (i) December 31, 2021, (ii) the time at which the Company has mined and removed all leased coal, or (iii) termination of the lease; and (3) the remainder term, from the end of the Primary Term until the Company has completed reclamation, environmental and other obligations under the lease. The Primary Term can be renewed twice for a period of five years each.

The Company is required to pay a tonnage royalty for each ton of leased coal mined and sold, and a monthly minimum rental fee. Each month’s tonnage royalty will be credited against the monthly minimum rental fee such that no minimum rental payment shall be due in any month where tonnage royalties equal or exceed the minimum rental. The Company is also required to pay a wheelage fee for any coal mined from adverse lands and transported through the leased premises.

The Company must produce and ship no less than 500,000 tons of leased coal from the leased premises during the calendar year ending December 31, 2014 and during each calendar year thereafter. Failure to do so will result in the payment of additional fees under the lease.

Charolais Corporation

In January 2007, the Company acquired assets and shares of the Charolais Corporation and related entities for a total consideration of \$21,924,000 principally allocated as follows:

Real property	\$ 557,000
Plant and equipment	13,483,000
Mining rights and mineral reserves.....	8,705,000
Asset retirement obligations	(821,000)
	<u>\$ 21,924,000</u>

The purchase price paid to the seller was \$21,735,000, including 434,640 common shares of the Company valued at \$543,000. In addition, the Company incurred \$189,000 of transaction costs related to the purchase. The purchase both expanded the Company’s reserve base in the Western Kentucky markets, and increased sales volume with a well established utility.

NOTE E — PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment consists of the following at December 31:

	<u>2008</u>		
	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value</u>
Land	\$ 1,474,574	\$ -	\$ 1,474,574
Building and improvements.....	25,424	7,698	17,726
Preparation plant.....	3,084,768	347,416	2,737,352
Mining equipment.....	45,886,694	5,758,494	40,128,200
Loading and marine transport equipment	1,775,000	340,208	1,434,792
Office equipment	370,450	158,172	212,278
Vehicles	65,965	32,983	32,982
	<u>\$ 52,682,875</u>	<u>\$ 6,644,971</u>	<u>\$ 46,037,904</u>

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	2007		
	Cost	Accumulated Depreciation	Net Book Value
Land.....	\$ 599,654	\$ -	\$ 599,654
Building and improvements.....	25,424	5,156	20,268
Preparation plant.....	1,476,805	260,003	1,216,802
Mining equipment.....	27,684,863	2,393,571	25,291,292
Loading and marine transport equipment	1,775,000	162,708	1,612,292
Office equipment	324,684	82,585	242,099
Vehicles	65,965	19,790	46,175
	<u>\$ 31,952,395</u>	<u>\$ 2,923,813</u>	<u>\$29,028,582</u>

In 2008, the Company sold several pieces of non-core equipment, generating gross proceeds of \$683,912. The Company recorded a loss of \$1,012,780 related to these sales.

In November 2007, the Company sold certain assets and reserves to Covol Fuels No. 2, LLC (“Covol”) for \$4,230,000 in cash. The assets comprised a permit, lease, mobile equipment, a preparation plant and slurry reserves. As part of the agreement, the Company entered into a coal purchase and sale agreement to purchase the processed coal fines from Covol and a coal processing agreement to enable the Company to temporarily wash its coarse coal product at the preparation plant. In addition to the Covol sale, the Company also sold non-core real estate for gross proceeds of \$1,926,951, and other smaller, non-core assets such as mobile equipment during 2007. The Company incurred net losses of \$1,810,138 related to the disposal of these assets in 2007.

NOTE F — ASSET RETIREMENT OBLIGATIONS

The Company estimates its ARO liabilities for final reclamation and mine closure based upon detailed engineering calculations of the amount and timing of the future cash spending for a third party to perform the required work. Spending estimates are escalated for inflation and then discounted at the credit-adjusted risk-free rate, which ranged from 6.12% to 7.64% at December 31, 2008 and 6.53% at December 31, 2007. Total estimated undiscounted future cash spending related to the ARO liabilities totaled \$5,142,000 at December 31, 2008, with spending estimated to occur from 2009 to 2016. Total estimated undiscounted future cash spending related to the ARO liabilities totaled \$4,437,000 at December 31, 2007. The Company records an ARO asset associated with the discounted liability for final reclamation and mine closure. The obligation and corresponding asset are recognized in the period in which the liability is incurred. The ARO asset is amortized on the units-of-production method over its expected life and the ARO liability is accreted to the projected spending date. As changes in estimates occur (such as mine plan revisions, changes in estimated costs or changes in timing of the performance of reclamation activities), the revisions to the obligation and asset are recognized at the appropriate credit-adjusted risk-free rate. The Company also recognizes an obligation for contemporaneous reclamation liabilities incurred as a result of surface mining. Contemporaneous reclamation consists primarily of grading, topsoil replacement, and revegetation of backfilled pit areas. A progression of the reclamation liability recorded on the consolidated balance sheet is as follows:

	2008	2007
Balance at beginning of year	\$ 3,757,353	\$ 1,536,948
Liabilities acquired	1,131,000	821,000
Liabilities incurred.....	166,083	1,339,052
Accretion	189,132	60,353
Liabilities settled.....	(919,568)	—
Total asset retirement obligations	<u>4,324,000</u>	<u>3,757,353</u>
Less current portion	<u>1,958,000</u>	<u>1,667,000</u>
	<u>\$ 2,366,000</u>	<u>\$ 2,090,353</u>

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NOTE G — DEBT

Revolving Line-of-Credit

Prior to July 2008, the Company had a \$3.1 million secured line-of-credit agreement with a bank for working capital purposes. The line-of-credit was collateralized by general business assets of the Company, including but not limited to equipment, accounts receivable and inventories. On July 7, 2008, there was no balance owing on the line of credit facility when the Company terminated the line of credit. The collateral has since been released. The line bore interest at the LIBOR rate plus 4% (8.60% at December 31, 2007). There was no outstanding balance on the line-of-credit at December 31, 2007.

Preferred Shares

In 2007, the Company conducted a preferred share offering. Preferred shares were issued in August 2007 and the proceeds used for working capital and the reduction of outstanding debt. The holders of preferred shares had the right to that number of votes equal to the number of shares issuable upon conversion of the preferred shares. Subject to the restrictions of any credit facility that may have been in effect, the preferred shares paid a 6.5% per annum cumulative dividend upon redemption or in common shares upon conversion. Additionally, holders of Series C common shares could exchange one common share for one preferred share for every preferred share purchased. Proceeds received and preferred shares issued in the third and fourth quarters of 2007 related to the preferred share offering, less related expenses, were as follows:

	Shares	Per Share	Total
Preferred shares	36,207,600	\$1.25	\$ 45,259,500
Common shares converted to preferred shares	982,667	1.25	1,228,334
Issue costs			(3,592,198)
Totals as at December 31, 2007	37,190,267		\$ 42,895,636

Preferred shares could have been converted by the holder at any time to common shares based on a conversion formula incorporating the issue price of the preferred shares and subsequent values of common shares. The preferred shares would be converted automatically into common shares upon the closing of an underwritten public offering of common shares of the Company or if the holders of a majority of the preferred shares consented to the conversion into common shares. Additionally, subject to various restrictions and the automatic and voluntary conversion provisions noted, commencing one year after issuance of the preferred shares, the holder could request redemption of the preferred shares at its issue price (\$1.25 per share) plus any unpaid dividends.

Due to the redemption features, GAAP required the preferred shares to be recorded as debt. Costs related to the preferred offering were netted against the liability. The liability was being accreted to its face value using the effective interest rate method and the accretion recorded as interest expense. Dividends due on the preferred shares were also included in interest expense, which totaled \$1,467,165 and \$1,277,838 for the years ended December 31, 2008 and 2007, respectively. The net carrying value of the preferred shares, including accrued dividends of \$1,277,838, was \$45,635,369 at December 31, 2007.

On June 27, 2008, in conjunction with the RTO, the preferred shares and accrued preferred dividends were converted to common shares at the conversion price of \$1.25 per share. The carrying value of the preferred shares prior to the conversion was reclassified to common equity. A summary of the conversion is as follows:

	Common Shares Issued at \$1.25	Dollars
Preferred shares issued	37,190,267	\$ 46,487,833
Preferred shares offering costs net of accretion	—	(310,115)
Preferred share dividends accrual	2,196,003	2,745,004
Amounts reclassified to common shares	39,386,270	\$ 48,922,722

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Bridge Loan

In November 2007, the Company entered into a loan agreement with a finance company, acting as administrative agent for a syndicate of lenders, for Cdn\$6,000,000. The note was collateralized by, among other things, the assets of PACT, was scheduled to mature on October 31, 2008, and bore interest at 12%. Interest on the note was paid monthly. The principal amount of the loan could be converted, in whole or in part, by the lenders at the time of an initial public offering of securities of the Company, at a conversion price equal to 90% of the offering price. The value of the note was adjusted to U.S. dollars based on current exchange rates, and any adjustments were charged or credited to the consolidated statement of operations. As consideration for the loan, the Company paid to the lenders a non-refundable \$600,000 bonus in the form of 480,000 common shares at a deemed price of \$1.25 per share. The value of the outstanding loan was \$5,526,785 net of unamortized loan fees as at December 31, 2007.

In May 2008, the Company modified its loan agreement with the finance company, acting as administrative agent for a syndicate of lenders, that initially loaned the Company Cdn\$6,000,000 in November 2007. The Company borrowed an additional Cdn\$5,000,000 million (the "Additional Loan"). The net proceeds of the Additional Loan after fees and converting to U.S. dollars was \$4,877,000. The terms and conditions of the loan agreement were substantially the same except for the conversion price employed should the lenders exercise their right to convert the principal amount of the loan to common equity. The principal amount of the loan (including the initial loan, which was amended at the time of the Additional Loan) was convertible, in whole or in part, by the lenders at the time of an initial public offering of securities of Phoenix or reverse takeover involving Phoenix (a "Going Public Transaction") at a conversion price equal to 80% of the Going Public Transaction offering price. As consideration for the Additional Loan, the Company paid to the lenders a non-refundable \$510,204 bonus in the form of 408,163 common shares at a deemed issue price of \$1.25 per share.

On June 13, 2008, the Company and the finance company, on behalf of each of the lenders, entered into an agreement clarifying the terms of the loan agreement modified in May 2008 pursuant to which, provided that no event of default had occurred, (A) immediately prior to completion of the direct share exchange, expected to occur on or before June 30, 2008, the principal amount of the loans would be fully converted into common shares of the Company at a conversion price of \$1.25 per common share, such that upon conversion, the finance company (or its designees) would receive a number of common shares equal to Cdn\$11,000,000 divided by \$1.25 (based on the Canadian dollar to United States dollar exchange rate at the time of the conversion), and (B) no adjustment to the number of bonus common shares issued in connection with the loans would be required. The agreement was conditional upon, among other things, the offering closing on or prior to July 2, 2008.

As a result of the modifications of the conversion terms of the November 2007 debt, pursuant to EIC-96, Accounting for the Early Extinguishment of Convertible Securities through Early Redemption or Repurchase and Induced Early Conversion, the Company distributed an estimated 499,000 additional common shares to the lenders related to the November 2007 debt of Cdn\$6,000,000, since the conversion price decreased from 90% of the offering price to \$1.25. As a result of the additional common shares distributed, the Company recorded a charge to accumulated deficit and an offsetting increase to share capital of \$808,258.

On June 23, 2008, the finance company, on behalf of each of the lenders, elected to convert the entire principal amount of the loan into common shares of the Company. Based on a loan value of \$10,835,000, and a conversion price of \$1.25 per share, the Company issued 8,668,000 common shares to the lenders. The loan value of \$10,835,000, less unamortized loan costs of \$558,318, was credited to share capital. The assets collateralizing the loan have been released.

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Long Term Debt Summary

Long-term debt consists of the following at December 31:

	2008	2007
Bank notes payable, interest at 7.25% to 8.90%. Payments are made in monthly installments. The loans are collateralized by various pieces of equipment and mature April 2010.....	\$ 105,109	\$ —
Equipment notes payable, interest at 5.25% to 8.75%. Payments are made in monthly installments. The loans are collateralized by related assets with a net book value of \$26,773,902 as at December 31, 2008 and have maturity dates from May 2009 to December 2012.....	21,068,681	9,687,113
Total long-term debt.....	21,173,790	9,687,113
Less current portion.....	6,532,045	2,338,198
	\$ 14,641,745	\$ 7,348,915

Expected maturities of notes payable based on years ending December 31 are as follows:

2009.....	\$ 6,532,045
2010.....	6,543,338
2011.....	5,709,365
2012.....	2,389,042
	\$ 21,173,790

Interest Rate Swap and Other Debt

In 2006, the Company entered into an interest rate swap transaction whereby the interest payments on an original notional dollar amount of \$7,000,000 converted to a fixed rate of 8.10% compared to a variable rate of LIBOR re-measured on a quarterly basis. The notional amount decreased over the life of the swap agreement, which was due to expire in December 2011. The notional amount of the agreement was \$5,483,333 at December 31, 2007. Under the agreement, the Company paid or received the net interest amount monthly, with the monthly settlements included in interest expense.

In 2006, management designated the interest rate swap agreement as a cash flow hedging instrument, and determined the agreement met the requirements for hedge accounting under GAAP. In August 2007, the debt to which this swap was related was retired. As a result, the amount previously recorded in other comprehensive income was charged to interest expense in October 2007 and any future changes to the fair value of the swap either increased or decreased interest expense as the contract no longer qualified as an accounting hedge.

On July 15, 2008, the Company paid \$237,200 to terminate the swap. The fair value of the derivative was \$224,696 at December 31, 2007, and is included in accrued liabilities on the consolidated balance sheet on that date.

In December 2006, the Company received a \$500,000 advance as part of a bridge financing agreement associated with the Charolais acquisition completed in January 2007. The advance was repaid in January 2007 and reissued as part of the full bridge financing of \$4,135,600 denominated in Canadian dollars (approximately \$3.5 million in U.S. dollars). The loan was repaid in August of 2007 resulting in a foreign currency exchange loss of approximately \$418,000.

Interest Expense

Included in interest expense for the years ended December 31, 2008 and 2007 is \$955,048 and \$2,254,999, respectively, for interest on indebtedness initially incurred for a term of more than one year.

NOTE H — FINANCIAL INSTRUMENTS AND FINANCIAL RISK FACTORS

The Company has exposure to credit risk, liquidity risk, interest rate risk, and foreign currency risk. The Company's risk management objective is to protect earnings and cash flow and, ultimately, shareholder value. Risk management strategies,

PHOENIX COAL INC.

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as discussed below, are designed and implemented to ensure the Company's risks and the related exposure are consistent with the business objectives and risk tolerance.

Credit Risk: Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation.

The Company invests its cash and cash equivalents and short-term investments in a U.S. financial institution, which at December 31, 2008, carried Standard and Poor's investment ratings on their deposits of A to A-1. At December 31, 2008, approximately \$39,700,000 of the cash and cash equivalents balance was invested in a money market fund managed by this financial institution. In January 2009, the Company reduced this money market balance to approximately \$8,000,000, an amount that is guaranteed until April 30, 2009 by the U.S. Treasury Department under the Temporary Guarantee Program for Money Market Funds. The Company has not experienced any losses on its deposits with this financial institution.

The Company is also subject to credit risk from its trade accounts receivable. While economic factors can affect credit risk, the Company manages risk by providing credit terms on a case by case basis. Customers are primarily investment grade companies and quasi-governmental agencies. As a result, the Company has not experienced any instances of non-payment. Subsequent to December 31, 2008, the Company has collected all of its trade accounts receivable at December 31, 2008.

The Company also invests in short-term investments issued by the United States government, such as Treasury bills and Treasury notes. Historically, these types of investments have been AAA rated, so the Company does not anticipate any risk related to default on these investments by the issuer.

At December 31, 2008, the total fair value of assets subject to credit risk, including cash and cash equivalents (including restricted cash and investments), short-term investments, and trade accounts receivable totaled \$55,108,371.

Liquidity Risk: Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company manages its liquidity by ensuring that there is sufficient capital to meet short and long-term business requirements, after taking into account cash flows from operations and the Company's holdings of cash, cash equivalents and short-term investments. The Company also strives to maintain sufficient financial liquidity at all times in order to participate in investment opportunities as they arise, as well as to withstand sudden adverse changes in economic circumstances.

Management forecasts cash flows for its current and subsequent fiscal years to predict future financing requirements. Future requirements are met through a combination of credit commitments and access to capital markets. At December 31, 2008, the Company had \$40.6 million of cash, cash equivalents, and short-term investments.

The following are the maturities, excluding interest payments, reflecting undiscounted future cash disbursements of the Company's financial liabilities based on years ending December 31:

	2009	2010 to 2011	2012 and later
Trade accounts payable and accrued liabilities	\$ 6,470,390		
Long-term debt	6,532,045	\$ 12,252,703	\$ 2,389,042
Other long-term liabilities	-	241,372	241,371
	\$ 13,002,435	\$ 12,494,075	\$ 2,630,413

Interest Rate Risk: Interest rate risk is the risk borne by an interest-bearing asset or liability as a result of fluctuations in interest rates. Financial assets and financial liabilities with variable interest rates expose the Company to cash flow interest rate risk. The Company's most significant interest rate risk arises from its investments in marketable securities and cash equivalents. However, the maturity on these instruments is generally less than ninety days, thereby mitigating the exposure to the impact of changing interest rates.

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The Company's long-term debt consists of only fixed rate notes. The Company previously maintained a credit facility which bore variable interest rate based on LIBOR. This facility was retired on July 7, 2008.

The following represents the hypothetical annual future interest income that would be earned on the Company's cash and cash equivalents (including restricted cash and investments) and short-term investments, and the effect of a 1% change in the interest rates on these investments. The calculation uses the interest rates realized on these assets at December 31, 2008 and the balances of the investments at December 31, 2008.

Annualized Income Earned Using:

Interest rates in effect at December 31, 2008.....	\$ 834,200
Interest rates with a 1% decrease in rates.....	319,300
Interest rates with a 1% increase in rates	1,349,100

Currency Risk: The Company's functional currency is the U.S. dollar and the Company's sales are denominated in U.S. dollars. As the Company operates in an international environment, some of the Company's financial instruments and transactions are denominated in currencies other than the U.S. dollar. The results of the Company's operations are subject to currency transaction risk and currency translation risk. At December 31, 2008, the Company had no material financial instruments that were denominated in non U.S. currencies.

Fair Values: At December 31, 2008, the fair values of cash and cash equivalents (including restricted cash and investments), short-term investments, trade accounts receivable, and trade accounts payable and accrued liabilities approximated their carrying values because of the short-term nature of these instruments. The fair value of other long-term liabilities also approximated its carrying value. The fair value of the Company's long term debt, calculated using the present value of the scheduled debt payments, and using a credit adjusted risk free rate of 6.75%, was \$21,052,500 at December 31, 2008.

NOTE I — INCOME TAXES

The components of income tax expense for the years ended December 31 are:

	<u>2008</u>	<u>2007</u>
Current	\$ 37,838	\$70,155
Future	—	—
	<u>\$ 37,838</u>	<u>\$70,155</u>

The Company's income tax provision in 2008 and 2007 is all currently payable and consists principally of state taxes.

A reconciliation of the differences between the statutory U.S. federal income tax expense (benefit) and the Company's effective tax expense at December 31 is as follows:

	2008		2007	
	<u>Tax Amount</u>	<u>Effective Rate</u>	<u>Tax Amount</u>	<u>Effective Rate</u>
Federal taxes at statutory rates	\$ (10,998,379)	35.0%	\$ (9,096,897)	35.0%
State income taxes, net of federal benefit	(1,093,424)	3.6%	(865,526)	3.6%
Permanent items:				
Share-based compensation.....	2,291,022	(7.3%)	-	0.0%
Interest and fees on preferred shares.....	1,268,919	(4.0%)	1,072,977	(4.1%)
Other permanent items	44,348	(0.1%)	58,325	(0.2%)
Total current year permanent items	3,604,289	(11.4%)	1,131,302	(4.3%)
Change in valuation allowance attributable to current year activity	8,525,352	(27.2%)	8,901,276	(34.3%)
Income tax expense.....	<u>\$ 37,838</u>	<u>0.0%</u>	<u>\$ 70,155</u>	<u>0.0%</u>

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The expense for income taxes includes federal and state income taxes currently payable or receivable and those deferred or prepaid because of temporary differences between the financial statement and the tax basis of assets and liabilities. The Company records income taxes under the liability method. Under this method, future income taxes are recognized for the estimated future tax effects of differences between the tax basis of assets and liabilities and their financial reporting amounts based on enacted laws.

The future tax assets and liabilities recognized in the consolidated balance sheet are comprised of the following at December 31:

	2008	2007
Future tax assets:		
Net operating loss carry forwards	\$ 23,820,480	\$ 10,769,102
Share-based compensation.....	18,228	577,488
Asset retirement obligations	1,669,064	491,431
Mining rights	-	928,016
Vacation expense.....	79,370	-
Other	568	1,702
	25,587,710	12,767,739
Future tax liabilities:		
Mine development costs	(426,708)	(54,693)
Mining rights	(2,705,138)	-
Royalty expense.....	(190,073)	-
Tax over book depreciation.....	(7,884,915)	(1,964,971)
	(11,206,834)	(2,019,664)
Total.....	14,380,876	10,748,075
Valuation allowance	(14,380,876)	(10,748,075)
Net future taxes.....	\$ —	\$ —

As a result of losses from operations, management has recorded a valuation allowance against the total net future tax asset as they do not believe it is more likely than not these assets will be realized. At December 31, 2008, the Company had available net operating loss (NOL) carry forwards, to reduce future taxable income of approximately \$61,711,000 expiring through 2029. The future benefit of these NOL carry forwards may be limited on an annual basis and in total under Section 382 of the United States Internal Revenue Code as a result of prior ownership changes and depending on the extent of future ownership changes contemplated by the Company. As a result of its valuation allowance, the Company has not currently recognized any benefit for these losses in its consolidated financial statements.

Net Operating Loss Carryovers (20 year carryover):

	Loss	Expiring In	Amount
Expiring	2004	2025	\$ 305,000
	2005	2026	1,860,000
	2006	2027	6,089,000
	2007	2028	19,648,000
	2008	2029	33,809,000

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NOTE J — MAJOR CUSTOMERS

For the years ended December 31, 2008 and 2007 the Company's concentration of major customers was as follows:

	<u>2008</u>	<u>2007</u>
Number of primary customers	3	3
Percentage of coal sales	87%	89%
Accounts receivable due at year end.....	\$ 2,410,395	\$ 2,285,240

The Company has never experienced non-payment from any of these customers. All amounts due from these customers at December 31, 2008 have subsequently been collected.

NOTE K — COMMITMENTS AND CONTINGENT LIABILITIES

In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities including liabilities related to asset retirement obligations and financial obligations in connection with mining permits that are not reflected in the accompanying consolidated balance sheet. The Company does not anticipate any material losses as a result of these transactions. In accordance with Kentucky state law, the Company is required to post reclamation bonds to assure that reclamation work is completed. Outstanding reclamation bonds totaled approximately \$11 million at December 31, 2008 and approximately \$9 million at December 31, 2007. These bonds are secured by letters of credit or certificates of deposit issued by a bank equal to the amount of the outstanding reclamation bonds. At December 31, 2008, the letters of credit are collateralized by the restricted cash and certificates of deposit on the consolidated balance sheet of \$11,638,921. At December 31, 2007, the letters of credit were collateralized by general business assets of the Company and the restricted cash and certificates of deposit on the consolidated balance sheet of \$2,312,500. In July 2008, the Company agreed to increase its restricted cash collateral securing its letters of credit with its bank to 100% of the reclamation bonds outstanding. As a result, the letters of credit are only collateralized by the restricted cash balance, and the general business assets of the Company were released.

The Company leases certain office space and mining equipment over long-term operating leases running through 2009. Future minimum lease commitments under non-cancelable operating leases as at December 31, 2008, payable in 2009, totaled \$567,355.

A significant amount of the Company's coal reserves are controlled through leasing arrangements and non-cancellable royalty lease agreements under which future minimum lease payments are due.

In the ordinary course of business, the Company enters into contracts to purchase diesel fuel from local suppliers for physical delivery at specified prices. Pursuant to these contracts, the Company does not own a futures or options position in the purchased fuel. As at, and subsequent to, December 31, 2008, the Company has executed purchase contracts for a total of 2,688,000 gallons to be delivered in 2009 at a total cost of \$5,871,096, or an average weighted price of \$2.18 per gallon. In 2008, the Company purchased over 5,000,000 gallons of diesel fuel for use at its owned or managed operations.

As at, and subsequent to, December 31, 2008, the Company has committed to purchase approximately \$5,100,000 of mining equipment for its operations, with delivery scheduled during the first calendar quarter of 2009. The Company has received commitments from equipment finance companies to finance the purchase of the equipment, with interest rates ranging from 8.50% to 8.75%, terms of 36 to 48 months, and down payments totaling approximately \$765,000. The notes will be collateralized by the equipment purchased.

In conjunction with the sale of certain assets to Covol in 2007, the Company entered into a master coal purchase and sale agreement (the "**Master Agreement**") to purchase coal fines recovered and processed by Covol from two coal slurry reserves areas in Muhlenberg County, Kentucky defined in the Master Agreement as the Rock Crusher Reserves and the National Guard Reserves (collectively, the "**Slurry Reserves**"). The term of the Master Agreement runs through the exhaustion of the Slurry Reserves (the "**Term**").

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At December 31, 2008, for the remaining Term of the Master Agreement, Covol is obligated to deliver not less than 60,000 tons of coal fines per month. The Company agrees that it will purchase from Covol, pursuant to the terms of the Master Agreement including certain BTU and quality specifications, all of the coal fines produced by Covol from the Slurry Reserves up to 60,000 tons per month during the Term. The price for the coal fines shall be the contract price set forth in each confirmation attached to the Master Agreement, provided, however, that in no event shall the contract price be less than \$25.50 per ton for coal delivered from the Rock Crusher Reserves or \$24.50 per ton for coal delivered from the National Guard Reserves.

NOTE L — STOCK INCENTIVE PLAN AND WARRANTS

2007 Stock Option Plan of MCC

MCC adopted an incentive stock option plan in May 2007 (the “2007 Plan”) which provides that the board of directors of the Company may from time to time, in its discretion, and in accordance with TSX requirements, grant to directors, officers, employees and technical consultants to the Company, non-transferable options to purchase common shares, provided that the number of common shares reserved for issuance will not exceed 10% of the issued and outstanding common shares. Such options will be exercisable for a period of up to 5 years from the date of grant. Vesting terms will be determined at the time of grant by the Board of Directors.

In 2007, upon closing of an initial public offering, MCC granted to its directors and officers options to acquire 150,000 shares at a price of Cdn\$0.25 per share, exercisable for a period of five years from August 28, 2007.

The 2007 Plan remains in force and options issued prior to the RTO will continue to be governed by the 2007 Plan; however due to the approval of the 2008 Plan (defined below), no further options will be issued pursuant to the 2007 Plan.

2004 Stock Incentive Plan of Phoenix

Phoenix’s 2004 stock incentive plan (the “2004 Plan”) authorized Phoenix’s board of directors to grant options to its employees (including officers), directors and consultants. Pursuant to the 2004 Plan, Phoenix could issue “non-statutory options” and “incentive stock options” to purchase common shares of Phoenix as well as “stock purchase rights”. The number of common shares or rights of Phoenix authorized and reserved for issuance under the 2004 Plan was fixed at 8,297,411.

Stock options granted under the 2004 Plan were generally subject to vesting provisions of 25% at the end-of-year one from the date of grant and then evenly over the following 48 months. The options were granted at a price equal to 100% of the fair value of the Company’s common shares on the date of grant and have a ten-year term.

Upon completion of the RTO, each Phoenix stock option was cancelled and extinguished and the holder received a replacement option of the Company to purchase that number of common shares of the Company equal to the number of shares of Phoenix common shares issuable under the Phoenix option with no change in the exercise price of such options due to the nature of the exchange rate between United States dollars and Canadian dollars.

2008 Stock Option Plan of the Company

In connection with completion of the RTO, the Company adopted a new stock option plan (the “2008 Plan”) on May 20, 2008, which was effective upon the closing of the RTO.

The 2008 Plan is designed to advance the interests of the Company by encouraging employees, officers, directors and consultants to have equity participation in the Company through the acquisition of common shares. The current intention is to use the 2008 Plan for option grants to employees, officers, directors and consultants of the Company. Options granted under the 2008 Plan may be “incentive stock options” or “non-qualified stock options”. The 2008 Plan was approved by the shareholders of the Company in June 2008 and 13,500,000 common shares are reserved for issuance under the 2008 Plan.

The exercise price per common share is not to be less than the market price of the common shares at the time of the grant. The exercise period for each stock option is not to be more than ten years (five years in the case of an incentive stock option

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granted to a person who owns more than 10% of the issued and outstanding common shares). Options may be granted subject to vesting requirements.

Unless terminated earlier by the board of directors, the 2008 Plan will remain in effect until all options granted under the 2008 Plan have been exercised or forfeited, or have expired. However, no new options may be granted under the 2008 Plan more than 10 years from the date the Plan was originally adopted by the board of directors.

Information regarding stock option activity under the Plans follows:

	<u>2008 Activity</u>	
	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
2004 Phoenix Plan Common Share Options		
Balance, December 31, 2007	6,749,000	\$0.87
Granted	1,000	1.25
Exercised	(25,438)	0.25
Forfeited.....	(1,413,562)	0.43
Options outstanding at December 31, 2008.....	<u>5,311,000</u>	<u>\$0.98</u>
Options exercisable at December 31, 2008.....	<u>2,986,495</u>	<u>\$0.89</u>
Options Denominated in Canadian Dollars 2007 MCC Plan and 2008 Company Plan	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
Balance, December 31, 2007	150,000	Cdn\$0.25
Consolidated at 1:2.35	(86,170)	
Balance after consolidation.....	63,830	Cdn 0.59
Granted under 2008 Plan	9,397,000	Cdn 1.32
Voluntarily surrendered and cancelled under 2008 Plan	(5,050,000)	Cdn 1.75
Options outstanding at December 31, 2008.....	<u>4,410,830</u>	<u>Cdn\$0.83</u>
Options exercisable at December 31, 2008.....	<u>1,498,340</u>	<u>Cdn\$0.82</u>
	<u>2007 Activity</u>	
	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
2004 Phoenix Plan Common Share Options		
Balance, December 31, 2006	3,045,000	\$0.32
Granted	4,004,000	1.25
Exercised	(300,000)	0.42
Options outstanding at December 31, 2007.....	<u>6,749,000</u>	<u>\$0.87</u>
Options exercisable at December 31, 2007.....	<u>2,609,050</u>	<u>\$0.66</u>

Compensation cost of stock option grants is recognized straight-line over the options' vesting periods. Compensation expense related to stock options for the years ended December 31, 2008 and 2007 was \$5,935,289 and \$948,859, respectively. In November 2008, members of the board of directors and two senior executives voluntarily surrendered, and the Board concurrently cancelled, 5,050,000 options that had been issued to them in June 2008 concurrent with the Offering, of which 1,683,333 were fully vested at the surrender date. The voluntary surrender was not accompanied by a concurrent grant of a replacement award or other consideration to these executives. This surrender caused an acceleration of the related compensation costs under CICA Handbook Section 3870. Had these board members and employees not voluntarily surrendered these options, the related compensation expense for the 2008 fiscal year would have decreased by \$2,247,250.

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The options' fair value was determined using the Black-Scholes option-pricing model. Expected volatilities are based on comparable company historical share price movement and other factors. The cost relating to the stock-based compensation plans is included in general and administrative expenses in the accompanying consolidated statements of operations.

	<u>2008 Company</u>	<u>2007 Phoenix</u>	<u>2007 MCC</u>
Weighted average fair value per share of options granted.....	\$0.67 per share	\$0.73 per share	\$0.21 per share
Assumptions (weighted average):			
Risk-free interest rate	3.98%	4.37%	4.75%
Expected dividend yield	0.00	0.00	0.00
Expected volatility.....	0.40	0.40	1.25
Expected option life (in years)	10.00	10.00	5.00

At December 31, 2008, the following stock options were outstanding:

<u>Number of Options</u>	<u>Exercise Price</u>	<u>Expiration Date</u>
683,000	\$0.25	April, 2015
465,000	0.25	December, 2015
360,000	0.50	May, 2016
920,000	1.25	March, 2017
2,883,000	1.25	November, 2017
63,830	Cdn 0.59	August, 2012
1,797,000	Cdn 1.75	June, 2018
<u>2,550,000</u>	Cdn 0.18	November, 2018
<u>9,721,830</u>		

Phoenix Warrants

As part of the fee structure related to Phoenix's preferred share offering in August 2007, the underwriter received warrants to purchase 1,780,000 shares of the preferred shares of Phoenix at \$1.25 per share. The warrants expire 24 months following the date Phoenix consummates an initial public offering of its common shares. The warrants' total value of \$462,800 was determined using the Black-Scholes option pricing model. Assumptions used in the model were a risk free interest rate of 4.76%, dividend yield of 6.50%, and expected volatility of .40. The value of the warrants was charged to additional paid in capital. On June 27, 2008, under the terms of the Broker Agreement, the warrants were converted to warrants to purchase common shares of the Company at \$1.25 per common share and expire in June 2010.

Company Warrants

Under the terms of the Offering, 31,428,580 warrants were issued to the purchasers of the common shares offered. The warrants entitle the holder to purchase one common share for each warrant held at a price of Cdn\$2.25 per share. The warrants expire on June 25, 2010. The warrants total value of \$8,077,145 was determined by the underwriter of the Offering. The value of the warrants was charged to share capital.

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Information regarding the warrant activity follows:

	Number of Warrants	Weighted Average Exercise Price
Phoenix Preferred Share Warrants		
Balance, December 31, 2007	1,780,000	\$1.25
Converted preferred warrants to common warrants.....	(1,780,000)	1.25
Warrants outstanding at December 31, 2008.....	—	\$ —
	Number of Warrants	Weighted Average Exercise Price
Phoenix Common Share Warrants		
Balance, December 31, 2007	—	\$ —
Converted preferred warrants to common warrants.....	1,780,000	1.25
Warrants outstanding at December 31, 2008.....	1,780,000	\$1.25
Warrants exercisable at December 31, 2008.....	1,780,000	\$1.25
	Number of Warrants	Weighted Average Exercise Price
Warrants Denominated in Canadian Dollars		
Company Common Share Warrants		
Balance, December 31, 2007	100,000	Cdn\$0.25
Consolidated at 1:2.35	(57,447)	
Balance after consolidation.....	42,553	Cdn 0.59
Exercised	(11,850)	Cdn 0.59
Warrants issued with new common shares	31,428,580	Cdn 2.25
Warrants outstanding at December 31, 2008.....	31,459,283	Cdn\$2.25
Warrants exercisable at December 31, 2008.....	31,459,283	Cdn\$2.25

At December 31, 2008 the following warrants were outstanding:

Number of Warrants	Exercise Price	Expiration Date
1,780,000	\$1.25	June, 2010
30,703	Cdn 0.59	September, 2009
31,428,580	Cdn 2.25	June, 2010
33,239,283		

Total cash received from options and warrants exercised during the years ended December 31, 2008 and 2007 totaled \$12,838 and \$125,000, respectively.

Broker Options

Under the terms of the Offering, the agents received Brokers' Options entitling the agents to purchase in the aggregate 2,514,286 Brokers' Units. Each Broker Unit entitles the agent to purchase one common share for Cdn\$1.75 per share and one half warrant entitling the agent to purchase one additional common share for each full warrant at Cdn\$2.25 per share. The Brokers Options expire on June 25, 2010 and are all exercisable at December 31, 2008. The options total value of \$1,106,286 was determined using the Black-Scholes option pricing model. Assumptions used in the model were a risk free interest rate of 3.99%, no dividend yield, and expected volatility of .40. The value of the options was charged to share capital as a cost of the Offering.

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Stock Grants

In December 2007, the Company issued 400,000 restricted shares to four of its directors. The shares were valued at \$500,000 and the related expense is included in general and administrative expenses. At the date of issue, the shares could not be sold until the Company closed a public offering of its shares. Following the Offering in June 2008, the shares are no longer restricted.

NOTE M— DEFINED CONTRIBUTION PLAN

The Company has a retirement savings trust plan in effect for substantially all full-time employees. The Plan also contains a deferred salary arrangement under IRC Section 401(k). Under the deferred salary arrangement, employees can contribute up to 100% of their earnings and the Company may match a portion of the employee contributions. The Company paid and charged to operations approximately \$629,000 and \$556,000 for the years ended December 31, 2008 and 2007, respectively, for Plan contributions.

NOTE N— RELATED PARTY TRANSACTIONS

The Company enters into transactions with shareholders and/or affiliated entities that have some level of common ownership with the Company. A summary of the related party transactions and balances follows for the years ended December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Expenses:		
Consulting fees.....	\$ 156,000	\$ 610,000
Rent and miscellaneous.....	32,925	65,377
Accounts receivable	—	16,858
Accounts payable	—	6,670

The above expense amounts were paid to MHI Energy Partners, LLC, which amounts were applied towards, among other things, salaries, overhead and benefits for individuals who provided services. These transactions are also in the normal course of business, and are recorded at the consideration established and agreed to by the related parties. David Wiley and Timothy Fogarty were managing directors of MHI Energy Partners, LLC. David Wiley is currently an officer and director of the Company and Phoenix, and Tim Fogarty resigned as a director of Phoenix in September 2008. During the second quarter of 2008, the Company discontinued these payments to MHI.

NOTE O — SUBSEQUENT EVENTS

On January 8, 2009, the Company announced that it received a 404 Permit granted by the U.S. Army Corps of Engineers (“COE”). With the 404 Permit, the Company secured all of the necessary permits to begin mining on the Radio Hill section of the Briar Hill surface mine (“Radio Hill”) in Muhlenberg County, Kentucky. During December 2008, Phoenix had obtained a permit required under Section 401 of the Clean Water Act (“401 Permit”) and a state mining permit granted by the KDNR for Radio Hill.

On March 4, 2009, the Company announced that it received a 404 Permit for its Winn North property, which is part of the Back in Black mine. With the 404 Permit, the Company secured all of the necessary permits to begin mining on Winn North in Muhlenberg County, Kentucky. During December 2008, Phoenix had obtained a 401 Permit and a state mining permit granted by the KDNR for Winn North. In addition, the Company announced it received two out of the three required permits for KO. The state mining permit from the KDNR had been issued conditionally, pending the outcome of a phase one archaeological study. When the phase one study is complete the condition will be lifted; however, the conditional permit allows for initial development of KO. The 404 Permit, which was originally protested in September 2008, is still outstanding on this property.

PHOENIX COAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008 and 2007

On March 3, 2009, the Company entered into a mutual release and settlement agreement with one of its customers to terminate a coal supply agreement for delivery of coal in 2009 and 2010 (the “2009/2010 Supply Agreement”). In consideration for terminating the 2009/2010 Supply Agreement, the Company paid the customer \$3,000,000 in cash. The payment relieved the Company of the obligation to deliver approximately 970,000 tons of coal, 470,000 in 2009 and 500,000 in 2010. In addition, the Company agreed to make up in 2009 approximately 170,000 tons of shipments that were not delivered in 2008 under a separate coal supply agreement dated January 1, 2008 (the “2008 Supply Agreement”). In return for fulfilling the 2008 Supply Agreement, the customer agreed to change the guaranteed monthly average BTU specification from 11,500 to 11,200. The \$3,000,000 payment will be charged to the consolidated statement of operations in 2009.